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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 917

W. H. COCKE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW, JURISDICTION, AND STATUTE INVOLVED

The opinions below, the basis for this Court's jurisdiction, and the statute involved are adequately set forth in the petition.

QUESTION PRESENTED

Whether petitioners, as the carried parties in an oil and gas venture whose allocable share of the drilling and development expenses was advanced by the

operator as carrying party, were entitled to include in their depletion base the production income which the carrying party retained as reimbursements for the advances and which was the only source of reimbursement available to the carrying party.

STATEMENT

William H. Cocke, Sr., William H. Cocke, Jr., and their wives ("petitioners"), were parties to two agreements for the drilling and development of oil and gas properties. The agreements involved petitioners' leasehold working interests and other mineral interests in St. Martin Parish, Louisiana (the "Goodrich K" properties), and Iberia Parish, Louisiana (the "Bayou Postillion" properties). (Pet. App. 46-47.)

The Goodrich K. contract was entered into on October 12, 1955. Under it R. H. Goodrich, and petitioner Cocke, Sr., entered into a joint operating agreement with Humble Oil and Refining Company to drill and develop the Goodrich K properties. Humble was designated the operator with control of exploration, drilling and development, and was given a 50 per cent interest in production. Petitioners Cocke, Sr., and Goodrich were designated non-operators and were each given a 25 per cent interest in production. Humble was obligated to advance all expenses and was entitled to reimburse itself for the non-operators' share of the expenses only out of one-half of the non-operators' 50 per cent share of the production income, if any. (Pet. App. 46-47.)

The Bayou Postillion contract, entered into on January 1, 1956, involved interests owned by Humble, the

California Company, petitioners and Goodrich. Humble was designated operator and was given a 40.302 per cent interest in production. The California Company was given a 48.06 per cent interest as a non-operator. Goodrich and petitioners, also as non-operators, were given an 11.638 per cent interest among them. Humble and California were required to advance all of the costs of drilling and development and could recoup the proportionate share of these outlays chargeable to petitioners and Goodrich only out of the income, if any, from one-fourth of their proportionate interest of 11.638 per cent. (Pet. App. 47-48.)

In their respective income tax returns for 1957 and 1958, petitioners reported as income the amounts which were recouped by Humble from production income to pay petitioners' share of the costs of drilling and development of the Goodrich K and Bayou Postillion properties. Petitioners also claimed the following deductions: (1) percentage depletion based on the proportionate share of drilling and development costs; (2) a similar proportionate share of intangible drilling and development costs incurred by Humble; and (3) a similar proportionate share of depreciation of the amounts paid by Humble for tangible assets used in developing the properties. (Pet. App. 49.)

The Commissioner of Internal Revenue determined that the portion of production income allocable to petitioners' proportionate shares which Humble retained to reimburse itself for production costs was not petitioners' income but was Humble's.[1] Accordingly, to

[1] Since the filing of the petition, petitioners' counsel has called to our attention the fact that the district court's find-

the extent they were based on such income, the deductions claimed by petitioners for depletion, intangible drilling and development costs, operating expenses, and depreciation were disallowed.[2] (Pet. App. 50.)

In petitioners' timely refund suit, the district court, relying on *Commissioner* v. *J. S. Abercrombie Co.*, 162 F. 2d 338 (C.A. 5), rendered judgment for petitioners. (Pet. App. 35-38, 51.) After a rehearing *en banc*, the court of appeals concluded (Pet. App. 83-84), that its "decision in *Abercrombie* must be overruled" (Pet. App. 40), and reversed.

ARGUMENT

The decision below is correct, and though there is a conflict it is not one which warrants further review.

1. The basic features of carried interest transactions may be illustrated by a simplified example in which an oil and gas venture is launched by two parties who share equally in the working interest. Under this type of arrangement, the parties agree that one of them (the "carrying" party) shall advance all of

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ings, as reprinted in the Appendix to the petition (at pp. 33-34), erroneously contain the word "not" in five places in the phrase "the amount not retained by Humble". This occurs on page 33 in the eighth and second lines from the bottom and on page 34 in the fourth, eighteen and twenty-sixth lines from the top. However, the district court's findings in this respect failed to describe accurately the government's position and the insertion of the word "not" is required to correct that description.

[2] The income reported and expenses claimed by petitioners but disallowed by the Commissioner also had been reported and claimed by Humble on its return. The Commissioner accepted that treatment. (Pet. App. 50, fn. 15.)

the costs of drilling and development with the right to recoup the share advanced for the other ("carried") party solely from a specified portion of the carried party's share of production. The carried party is not personally liable for costs and loses nothing if there is no production; on the other hand, if there is production, the carrying party has an absolute right to receive the specified portion of production income allocable to the carried party's interest until the former has recouped expenses advanced for the latter. Only after such recoupment (or payout, as it is usually called) does the carried party have the right to share equally in production income.[3]

The question is whether the portion of production income which is shifted pending payout from the carried to the carrying party is income for tax purposes

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[3] In the case at bar, these arrangements were made without disturbing the parties' proportionate interests in the oil and gas properties. There are two other types of carried interest arrangements. In the "Manahan" type (*Manahan Oil Co.* v. *Commissioner*, 8 T.C. 1159), the owner of the working (or leasehold) interest assigns the entire working interest, or fraction thereof, for a period of time measured by the period required for the recoupment of the development costs by the assignee. When such recoupment is accomplished, a portion, of the working interest reverts to the assignor. In the "Herndon" type of carried interest (*Herndon Drilling Co.* v. *Commissioner*, 6 T.C. 628), the owner of the working interest may assign an undivided fraction thereof, together with a production payment measured in terms of dollars of expenditures incurred by the assignee for the benefit of the assignor, which is payable out of the assignor's retained fractional interest. See Breeding and Burton, *Income Taxation of Oil and Gas Production* (1961 ed.), Sections 8.16 and 8.17; Hambrick, *Another Look At Some Old Problems—Percentage Depletion and the ABC Transaction*, 34 Geo. Wash. L. Rev. 1, 29 (1965).

to the former or to the latter. Whichever party must include the amount in income is also entitled to include it in his depletion base and to claim deductions for the proportionate share of intangible drilling and development costs, operating expenses, and depreciation.

In *Commissioner* v. *J. S. Abercrombie Co.*, 162 F. 2d 338, the Fifth Circuit held that this shifted portion of production income was the carried party's income. The court viewed income as necessarily following title, *i.e.*, as taxable to the parties (and hence includible in their depletion bases) in proportion to their legal interests in the property regardless of who, under their agreement, bore the expenses and had the risk of loss in the absence of production. The court regarded the carrying party's payment of the carried party's share of expenses as a "loan" which did not derogate from the carried party's right to deduct such expenses and claim depletion in the income.

In the case at bar, after rehearing *en banc*, the court overruled *Abercrombie*. Rejecting the *Abercrombie* ruling that title controls, the court held that the economic interest concept is the relevant touchstone and that petitioners, as carried parties (Pet. App. 61), "had no economic interest in the oil which produced the income questioned here." By way of corollary, the court further held that petitioners were not entitled to include the income in their depletion base, and were not entitled to deductions for expenses and depreciation since—as carried parties—they had not paid expenses or invested in equipment.

2. The decision here is sound. The economic interest concept, evolved by this Court in mineral cases,

governs the allocation between taxpayers of production income and depletion deductions attributable thereto, without regard to the portion of a mineral property to which a taxpayer may hold title under general principles of property law. A taxpayer holds a depletable economic interest to the extent that he has acquired by investment an interest in minerals in place and secures, by any form of legal relationship, income derived from extraction to which he must look for a return of his investment. *Palmer* v. *Bender*, 287 U.S. 551; Treasury Regulations on Income Tax (1954 Code), Section 1.611-1(b)(1) (26 C.F.R. 1.611-1). "The technical title to the oil in place is not important". *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 603. A taxpayer's depletable economic interest continues so long as he looks solely to the mineral, if, as and when produced, for a return of his capital. *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 36; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312.

In carried interest transactions it is the carrying party who, until payout is completed, has the depletable economic interest in the specified portion of production to which he is entitled to look for recoupment of the costs he has advanced for the carried party's account. The carrying party has invested the costs advanced, and is dependent solely upon income derived from extraction—if, as and when there is production —for a return of his investment. Hence the portion of production income to which he is entitled, in recoupment of expenses advanced, is his taxable income and includible in his depletion base. By the same token,

he is entitled to the deductions for intangible drilling and development costs and depreciation; it is he and he alone who has been liable for, and has made, the expenditures which entitle a taxpayer to such deductions. Accord, *United States* v. *Thomas*, 329 F. 2d 119 (C.A. 9), certiorari denied, 379 U.S. 819.[4]

3. There is no conflict in decisions which now requires resolution by this Court (see Pet. 13 *et seq.*). While there are several early appellate cases which are not in accord with the instant decision, they have little if any remaining vitality in the light of intervening judicial history.

Reynolds v. *McMurray*, 60 F. 2d 843 (C.A. 10), certiorari denied, 287 U.S. 664, involved a transaction substantially similar to the one involved here. The Tenth Circuit's decision, rendered in 1932, was based (like *Abercrombie*) on the principle that income from property is to be taxed to the holder of legal title. However, that decision preceded this Court's initial formulation of the economic interest concept in *Palmer*

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[4] Petitioners' attempt (Pet. 21-22) to distinguish *Thomas* on the ground that it involved a net profits interest (a share of gross production measured by net profits) rather than a carried interest is without merit. While there are formal differences between the typical carried interest and net profits interest, both the carried party and the holder of the net profits interest have an economic interest only to the extent of the net amount they receive after the specified portion of production has been applied against the specified development expenditures made by the operator or carrying party. And both have no personal liability for payment of these expenditures. Therefore, as far as the issues of this case are concerned, the carried interest is, as the Ninth Circuit observed in *Thomas*, tantamount to a net profits interest.

v. *Bender*, *supra*. And because it was based on property law concepts rather than the economic interest concept, it was criticized and disapproved by the Ninth Circuit in *United States* v. *Thomas*, *supra*.[5] In the light of this Court's economic interest decisions and the later decisions of the Ninth and Fifth Circuits in *Thomas* and the instant case, it is doubtful whether the Tenth Circuit would subscribe to *McMurray* today.

T. K. Harris Co. v. *Commissioner*, 112 F. 2d 76 (C.A. 6), is another early appellate decision of questionable vitality. Moreover, it is distinguishable from the case at bar. In *Harris* the taxpayer, who owned real property, entered into an agreement with a gas company whereby the latter was to drill wells on the property at its own expense and to be reimbursed out of gas production. When the costs had been recovered, the wells were to become the property of the taxpayer, and the gas company was to continue operating the wells on specified terms and to buy the output. Thus, the gas company, unlike Humble in the present case, had neither a legal interest in the property nor an equity interest in the production enterprise. Although it was an independent contractor performing services for a fee and a purchaser of the mineral product, it never gained an economic interest in the minerals in place. Instead, the Sixth Circuit held that

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[5] The taxpayer's petition for a writ of certiorari in *Thomas*, alleged, as here, a conflict with *Reynolds* v. *McMurray* and *Commissioner* v. *J.S. Abercrombie Co.*, both *supra*. In its brief in opposition, the government responded that *McMurray* was an old case of questionable authority and that the scope of *Abercrombie* had been severely limited by the Fifth Circuit's decision in *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750.

the gas proceeds applied toward reimbursement of drilling costs constituted income to the taxpayer, which was used by him to purchase the completed wells. Such a rationale would be impossible on the facts of the present case, and petitioners do not urge the Sixth Circuit's approach here.[6]

4. Petitioners urge (Pet. 26) that even if the court of appeals was correct in overruling *Abercrombie*, the rule should have been applied prospectively only and not in the instant case. There have been, to be sure, instances where this Court has applied new rules prospectively only. One example is *James* v. *United States*, 366 U.S. 213, where this Court held that embezzled funds constitute income to the embezzler, overruling *Commissioner* v. *Wilcox*, 327 U.S. 404. But that was a criminal action, and, as the Chief Justice observed (366 U.S. 221-222), the existence of *Wilcox* during the tax years involved made it impossible to conclude that the defendant had an intent to avoid taxes when he failed to report the pro-

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[6] There is no conflict with *Louisiana Land and Exploration Co.* v. *Donnelly*, 394 F. 2d 273 (C.A. 5) (see Pet. 25). The issue there was whether the lessor of oil and gas properties holding a net profits interest was entitled to include in its depletion base a portion of local severance taxes paid by the lessee but attributable to the lessor's interest. The decision is consistent with the present case because the Fifth Circuit, in holding for the lessor, grounded its decision principally on its view that the lessor, under local law, bore the risk of loss upon nonpayment by the lessee.

Nor is *Crane* v. *Commissioner*, 331 U.S. 1, pertinent here (see Pet. 15, 19). The problem there was computation of gain on the sale of an apartment house originally acquired subject to a mortgage, a problem having no relation to the considerations of economic interest that are peculiar to mineral transactions.

ceeds of the embezzlement as income. And in *England* v. *Medical Examiners*, 375 U.S. 411, on which petitioners rely (Pet. 12-13, 26), the Court made clear that an abstention order remitting litigants to a State court for decision of a State issue does not compel assertion of associated federal claims in the State courts, but that voluntary submission of federal claims to the State tribunal bars their reassertion in the federal district court. This rule was not applied to the litigants in *England*, but that was because they had reasonably interpreted prior decisions as requiring them to assert federal claims in the State court, and they would otherwise have been unable to have their substantive rights determined by a federal tribunal.

The more usual course, however, is that the federal courts apply a new rule at least to the litigants in the case where the rule is adopted, even though the ruling may, in other similar cases, be given prospective application only. Thus, in *Stovall* v. *Denno*, 388 U.S. 293, although the Court limited the effect of a new constitutional rule to prospective application, it recognized that the rule should nevertheless control in the litigation in which it had been established (see 388 U.S. at 301). See, also, *Johnson* v. *New Jersey*, 384 U.S. 719; *DeStefano* v. *Woods*, 392 U.S. 631; *Fuller* v. *Alaska*, 393 U.S. 80.[7]

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[7] *Linkletter* v. *Walker*, 381 U.S. 618, on which petitioners rely (Pet. 12, 26), is not helpful to them. There this Court limited the retroactive effect of a new constitutional rule announced in a prior case to cases on direct review at the time that case—*Mapp* v. *Ohio*, 367 U.S. 643—was decided. That ruling was thus applied not only to the litigant in that case, but also to other litigants similarly situated.

In the final analysis, the federal courts have, at the least, ample discretionary authority to apply a new rule retrospectively. As the court of appeals said here (Pet. App. 74-75), " 'Pure prospectively,' even if constitutionally permissible, must be a matter of judicial grace sparingly invoked. Especially in the administrative melange of taxation, appeasement by mandating moratoria should not be readily granted." In federal civil tax cases retroactive application of corrected interpretations of the law has indeed been the general rule, with such rules being given full application to the open years of all taxpayers affected. *E.g.*, *Estate of Geiger* v. *Commissioner*, 352 F. 2d 221 (C.A. 8), certiorari denied, 382 U.S. 1012; *United States* v. *Siano*, 356 F. 2d 927 (C.A. 2), and *Nerem* v. *Commissioner*, 41 T.C. 338, all of which held that *James* v. *United States*, *supra*, applies to funds that were embezzled prior to the *James* decision. See, also, *Helvering* v. *Hallock*, 309 U.S. 106, 119; *Commissioner* v. *Estate of Church*, 335 U.S. 632, 647-650.

Petitioners have shown no extraordinary circumstances which would warrant prospective overruling of *Abercrombie*. Their claim (Pet. 26) that they relied upon the Commissioner's acquiescence in *Abercrombie*[8] in entering these transactions in 1955 and

[8] Petitioners' recital (Pet. 16-20) of the changes in the Internal Revenue Service's administrative position with respect to this issue does not diminish the correctness of the decision below and of *Thomas*. Certainly, the fact that in 1949 (1949-1 Cum. Bull. 1) the Commissioner withdrew his original non-acquiescence (1946-2 Cum. Bull. 6) to *Abercrombie* provides no basis for questioning his present position or for providing petitioners with any basis for tax relief. (In 1963, the

1956 must be weighed, as the court below did (Pet. App. 71-74), against the knowledge, widespread at that time, that the Service disputed the *Abercrombie* rationale. See *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750, 756-757.[9]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Commissioner withdrew his acquiescence and reinstated his original nonacquiescence (1963-1 Cum. Bull. 5.)) It is well settled, of course, that the Commissioner may correct his own mistakes of law retroactively, pursuant to Section 7805(b) of the 1954 Code. *Dixon* v. *United States*, 381 U.S. 68; *Automobile Club* v. *Commissioner*, 353 U.S. 180.

[9] The instant case does not, as petitioners contend (Pet. 26), present an issue of unusual importance in the administration of the Internal Revenue laws. We are advised by the Internal Revenue Service that there are 10 cases pendi ; which involve carried interest transactions, five of which involve the claims of the instant petitioners for subsequent taxable years. These are the same 10 cases that were pending as of the time of the court of appeals' decision. (See Pet. App. 75, fn. 27.)

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